Magellan
Planning Group, Inc.

# Charitable Remainder Trusts

CRATs & CRUTs

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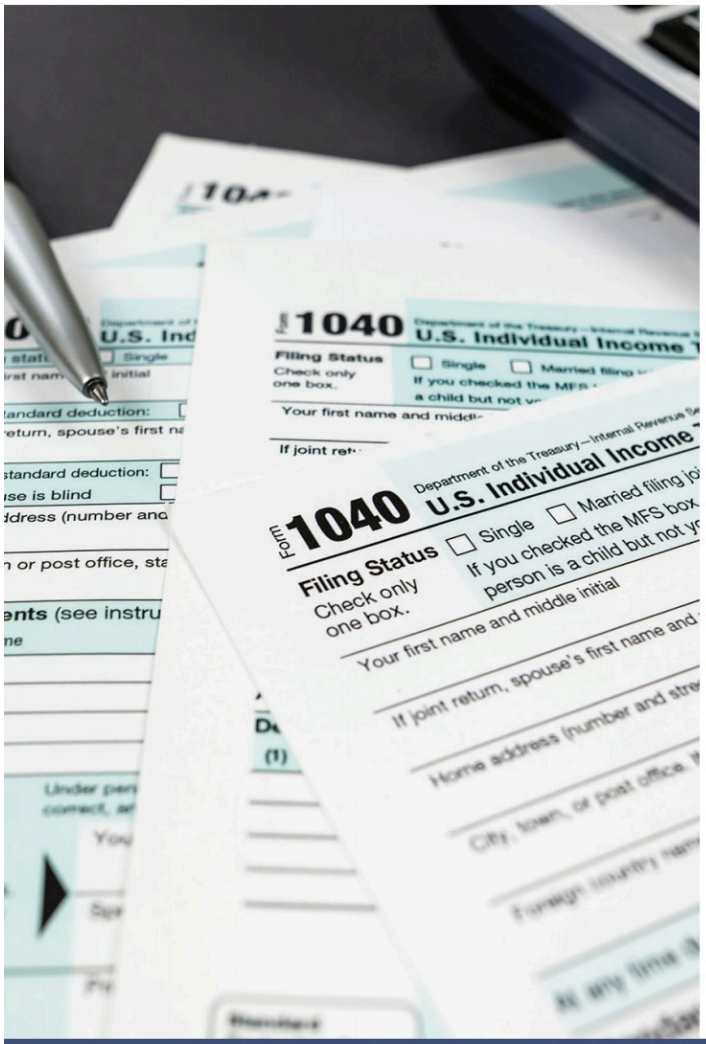
> *Government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.*
>
> -Ronald Reagan

# The Problem: Taxes




## Capital Gains Taxes

For property and assets that have appreciated over time, capital gains taxes can consume almost a third of their value, in effect making the IRS and state governments a large part-owner of your asset.

For example, an asset with a long-term gain of $1,000,000 could be subject to up to $298,000 in taxes! And collectibles are taxed at an even higher rate.

Also note that there is an additional 3.8% federal Medicare tax on capital gain sales, and of course whatever taxes your state imposes.

Additionally, a large gain appearing on your tax return can increase the taxation of other income such as pensions, IRA distributions, dividends, and even social security benefits.

## Estate and Gift Taxes

The estate tax exemption has changed frequently over the last three decades, ranging from $600,000 to over $12 million. The future value of the exemption is unknown, but taxation of an estate has historically been rather heavy, ranging from 40% to 55%.

The gift tax exemption has generally been the same as the estate tax exemption. In addition, there is an annual gift tax exclusion that must be used each year, or it is lost forever.

## Collectibles

The Taxpayer Relief Act of 1997, while lowering the maximum capital gains rate on gains from the sale of most assets to 20%, left the maximum rate on gains from the sale of collectibles at 28%. On top of that, there is an additional 3.8% federal Medicare tax on collectibles, and whatever taxes your state imposes.

The types of assets considered collectibles are listed in the Internal Revenue Code under Section 408(m) and proposed regulations. Collectibles under this section include:

**Any work of art**

**Any rug or antique**

**Any stamp or coin**
*(with limited exceptions)*

**Any metal or gem**
*(with limited exceptions)*

**Any alcoholic beverage**

**— AND —**

**Any other tangible personal property that the IRS determines is a "collectible" under IRC Section 408(m).**

This last category has been used as a catch-all. If it is rare, it is likely a collectible. Case law is replete with taxpayers not claiming a collectible that was later deemed so by the IRS, resulting in additional taxes, penalties, and interest.

## Depreciation Recapture

Owners of rental real estate or commercial property may have depreciated their buildings and improvements. Upon selling these properties, the owner will be required to recapture this depreciation (and pay taxes on it) in addition to any capital gain realized.

Your depreciation recapture is ultimately based on your normal income tax rate. Depreciation recapture is applied to any amount of your gain that can be attributed to the depreciation deductions you took previously. Additionally, if you are in a higher-than-average income tax bracket, you might also need to pay a 3.8% net investment income tax.

## Required IRA Distributions to Beneficiaries

Prior to the passage of the Secure Act in 2019, non-spousal beneficiaries of an IRA could "stretch" the decedent's IRA based on their own life expectancy, providing a significant tax savings to the beneficiary.

After 2020, this option is no longer available. Non-spousal beneficiaries are now required to distribute the entire IRA within a 10-year period. This is taxed as ordinary income on top of the taxable income the beneficiary is already earning, often driving their tax liability into higher brackets.

# A Solution: The Charitable Remainder Trust

**The good news is that there is a tried-and-true solution to every one of these tax problems.**

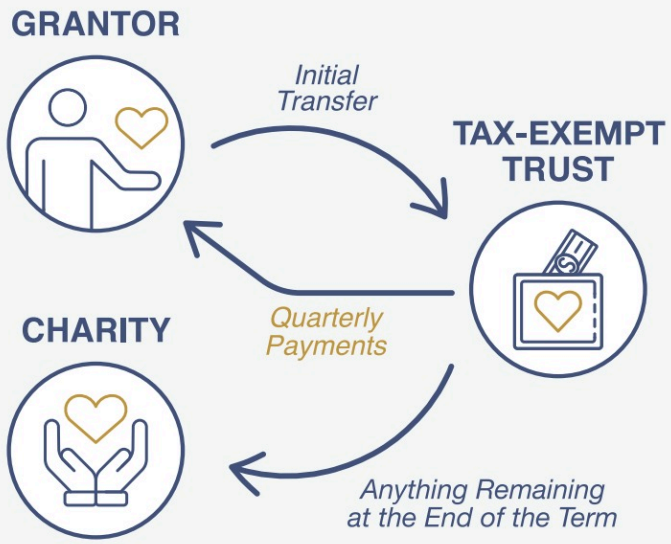
The **Charitable Remainder Trust** is a tax-exempt, irrevocable trust that is funded by donated assets (usually highly appreciated) which pays income to individual non-charitable beneficiaries for a period of lives and/or years, after which the remaining trust assets pass to qualified charities you have selected, or your family's Donor Advised Fund.

The **Testamentary Charitable Remainder Trust** (T-CRUT) is a special kind of trust created after your death where assets (usually a large IRA) are transferred to it tax-free. The trust then pays income to your chosen beneficiaries for a matter of lives and/or years, after which the remaining corpus (principal) transfers to charities you have selected, or your family's Donor Advised Fund.

The popularity of the T-CRUT has soared since the passage of the SECURE Act in 2019, which essentially eliminated the Stretch IRA for non-spousal beneficiaries, requiring complete payout over a ten-year period, with associated taxation. The T-CRUT is often used as a replacement for the stretch IRA since it allows many beneficiaries to receive payments based on their life expectancy.

Any assets transferred to a Charitable Remainder Trust are immediately removed from the taxable estate. This is also true of a Testamentary Charitable Remainder Trust. Both the CRT and the T-CRUT can be useful tools in reducing or eliminating estate and gift taxes.

**Here is the basic concept of a Charitable Remainder Trust:**



## Too Good to Be True?

We often get this question. The truth is that it is absolutely true. In fact, it comes right out of the tax code. The Charitable Remainder Trust provides significant benefits.

| 26 U.S. Code § 664 - The Charitable Remainder Trust | |
|---|---|
| — Created by Act of Congress in 1969 | — Removal from the taxable estate |
| — Clear IRS guidance and support | — Current income tax deduction |
| — Shelter from capital gains tax | — Increased cash flow with favorable tax treatment |
| — Asset protection | — A meaningful charitable legacy instead of meaningless taxes |

## What's the Catch?

When you study the inner workings of the Charitable Remainder Trust, you discover that essentially your bottom-line commitment to charity is 10%. This is to say that when the trust is initially funded, there must be at least a 10% remainder interest left to charity at the end of the trust term, and that may not be for 50 years or more!

So essentially you are trading all that tax liability today for a 10% charitable gift at some point in the future—perhaps fifty years hence. All the while, the trust is growing tax-free and income is being paid to you or your family. And you get to take a tax deduction today for your future charitable donation.

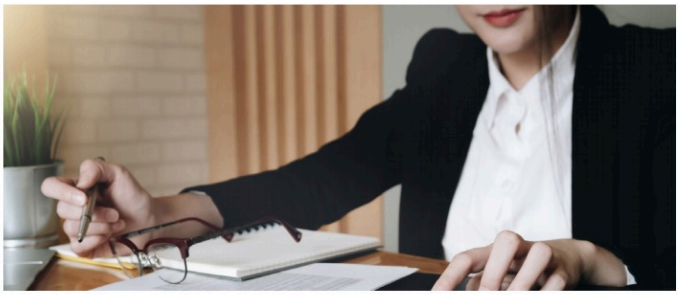
**There are two drawbacks to a Charitable Remainder Trust.**

The obvious one is that it is irrevocable and once assets have been transferred to the trust, you no longer have access to the entire principal. If your goal is to use the entire proceeds of the sale of your asset to buy a large ticket item like a yacht or a horse farm, the CRT is probably not for you.

As with any irrevocable trust, the other drawback is that there are initial establishment expenses and there is ongoing maintenance. The trust must be created by an attorney competent in irrevocable trusts, the assets need to be invested so that there is liquidity and no violations of various rules, annual tax forms must be filed, and four tier accounting must be maintained by a CPA competent in Charitable Trusts. The annual maintenance costs (CPA, attorney, investment advisor) are paid by the trust itself after the initial trust creation. Finally, and perhaps the most difficult hurdle, each of these parties need to communicate, cooperate, and coordinate.

# Common Payout Options

**Whether you are considering a Charitable Remainder Trust today or a Testamentary Charitable Remainder Trust upon your passing, the payout options to the non-charitable beneficiaries are the same. You, as the donor/grantor, choose the terms, but there are certain minimum requirements.**



The first requirement is that the payout rate must be at least 5%. The second requirement is that payments must be based on a period of lives, and/or years, not to exceed 20. The IRS provides guidelines and applicable interest rates on a monthly basis.

The IRS also provides us with life and term payout rates. As a general rule, the longer the term of payout, the lower the payout rate. For all of these calculations, the IRS provides actuarial values in IRS Publication 1458.

## Life Only

This payout is based on one life only. Just as it sounds, the payments will continue to the beneficiary for as long as that one person lives. Upon his or her passing, the payments will cease, and any remainder will pay out to charity. As with all life-only annuities, there is a risk that the annuitant (the person whose life the payments are based on) dies prematurely. In this case, your chosen charity will receive a larger amount that was initially calculated; so even then, there is no money lost to taxes or insurance companies. The benefit of this type of arrangement is that the payments are generally larger.

## Joint Lives

Similar to the single life payout, the joint life payout is based on multiple lives. This is generally used between spouses, but sometimes also among adult children, while being funded by the parents as part of their estate planning strategy. Obviously, more lives increases the chances that payments will continue for a longer total period because they will continue in full until the last person dies.

## Life plus Term of Years

The ability to combine a period of lives with a term of years certainly creates more flexibility in planning. Because of the uncertainly that is intrinsic to a life-only payout, oftentimes a single parent will want to include her children in future payments upon her death. This guarantees that if she dies prematurely, her children (or someone else) will at least receive payments for a period of stated years, not to exceed twenty.

## Joint Life plus Term of Years

One of the most common types of CRT arrangements is joint life plus a term of years. Usually set up by a couple for payments to be made to each of them for as long as they both live. At the death of the first beneficiary, both payments continue to the survivor. Upon the death of the second life beneficiary, payments continue to one or more “successor beneficiaries” for a period of years, not to exceed twenty. It is not uncommon to see estimated trust payout periods of fifty years or more.

# CRATs vs. CRUTs

**All charitable trusts come in two basic flavors: the Charitable Remainder Annuity Trust (CRAT) and the Charitable Remainder Uni-Trust (CRUT). The difference is mainly in how the non-charitable payout is calculated each year.**

An **Annuity Trust** begins with a certain payout dollar amount and pays that exact amount every year—very simple. The corpus (principal) of the trust may increase or decrease, but the payment will never change. Once an annuity trust is created and funded, no further assets may be added in the future.

Conversely, with a **Uni-Trust,** the payout percentage is fixed, but the end-of-year value may be higher or lower than the previous year, depending on the amount of the corpus.

The Uni-Trust payout rate is multiplied by the end-of-year value to determine the actual dollar amount of the non-charitable beneficiary payments in the coming year. Thus, it is possible (and almost certain) that payments will go up or down depending on the performance of the investments in the trust.

**Once a Uni-Trust is created, it can be funded multiple times, with each subsequent donation receiving a tax deduction.**

# The CRT Process from Start to Finish

**The logistics of the entire process require the coordination of three disciplines, and professionals with experience with charitable trusts.**

## 1 Create

The first step is to meet with an Estate Planning Attorney who can help you design the terms of the trust within the IRS guidelines and memorialize it on paper. The legal team will consider your goals and determine the optimum payout rate and the period of lives and/or years that will best achieve them. They will also apply for the trust's tax-exempt Tax Identification Number (EIN).

## 2 Donate

The legal team will also help to facilitate the transfer of the assets to the trust. Sometimes this may require deeds or assignments or other legal instruments. The donor/grantor signs to transfer assets and the trustee of the newly created CRT signs to accept the transfer of assets—often the same person. All of this must be facilitated by the legal team and it may be advisable to include the financial team at this point, especially if it is necessary to transfer securities or other financial instruments.

## 3 Tax-Deduction

Next up is the tax team to determine what your tax deduction will be. This is based on the remainder interest that is initially allocated to the charitable component of the trust on the day that the assets are "donated." Remember, to qualify, this remainder must be at least ten percent based on the original calculations. The deduction may be spread out over a period of up to five years, depending on your personal tax situation.

## 4 Sale

Now is the time to liquidate the assets that have been donated to the trust. With stocks and other liquid investments, this is pretty straightforward. With real estate and other unique items, there is usually a buyer already identified, with cash ready to go. It is not possible to encumber the trust with a loan or mortgage, so the trust assets cannot be pledged. The CRT must now open an account to receive the funds from the liquidation.

## 5 Reinvest

Once funds have been received into the trust account, they can then be reallocated among ten to fifteen asset classes, based on the size of the trust and the risk tolerance of the primary class of income beneficiaries. If managed properly, the long-term capital gain tax characterization will carry over to the income beneficiaries. Mismanagement of the trust corpus could cause the distributions to be recharacterized as ordinary income, which might be detrimental to the beneficiaries.

## 6 Income

As soon as the assets are received by the trust, the distribution of income begins. Generally, income is paid quarterly, but must at least be paid annually. Part of the financial team's responsibility is to provide liquidity for payments and steady dependable income to the current beneficiaries, while preserving and growing the corpus for the future beneficiaries and the charities.

## 7 Form 1098 & K-1 Reporting

The coordination and cooperation between the tax team and the financial team help to retain the tax characterization of most payments as long-term capital gain. Though no taxes are due by the trust, the tax team must prepare the annual accounting for the IRS, and distribute K-1's to all the non-charitable income beneficiaries.

## 8 Final Distribution to Charity(ies) or DAF

At long last, after all the lives and/or terms have run, any assets remaining in the trust are distributed according to the grantor's wishes. During the term of the trust, the grantor/donor retained the right to change or reallocate final distributions to charitable organizations as long as they qualified under section 501(c)(3). Those charities will now receive the balance of the trust as a lump sum and the trust account will be closed.

Another very popular option is to make the final distribution to a Donor Advised Fund (DAF), in which case the remaining balance of the trust will be directed to a new account in the name of the DAF. This account will remain open and continue being invested, with distributions being made to charities of the descendent's choosing. This is a wonderful way to create a lasting legacy while instilling charitable intent to the next generation.

# Trust Maintenance

**There are no gray areas with the Charitable Remainder Trust.**

26 U.S. Code § 664 spells out the rules clearly, and court decisions and IRS guidance since 1969 have helped us to fine tune our tri-disciplinary system of successfully creating and maintaining Charitable Trusts. Here are some of the rules regarding all Charitable Trusts.

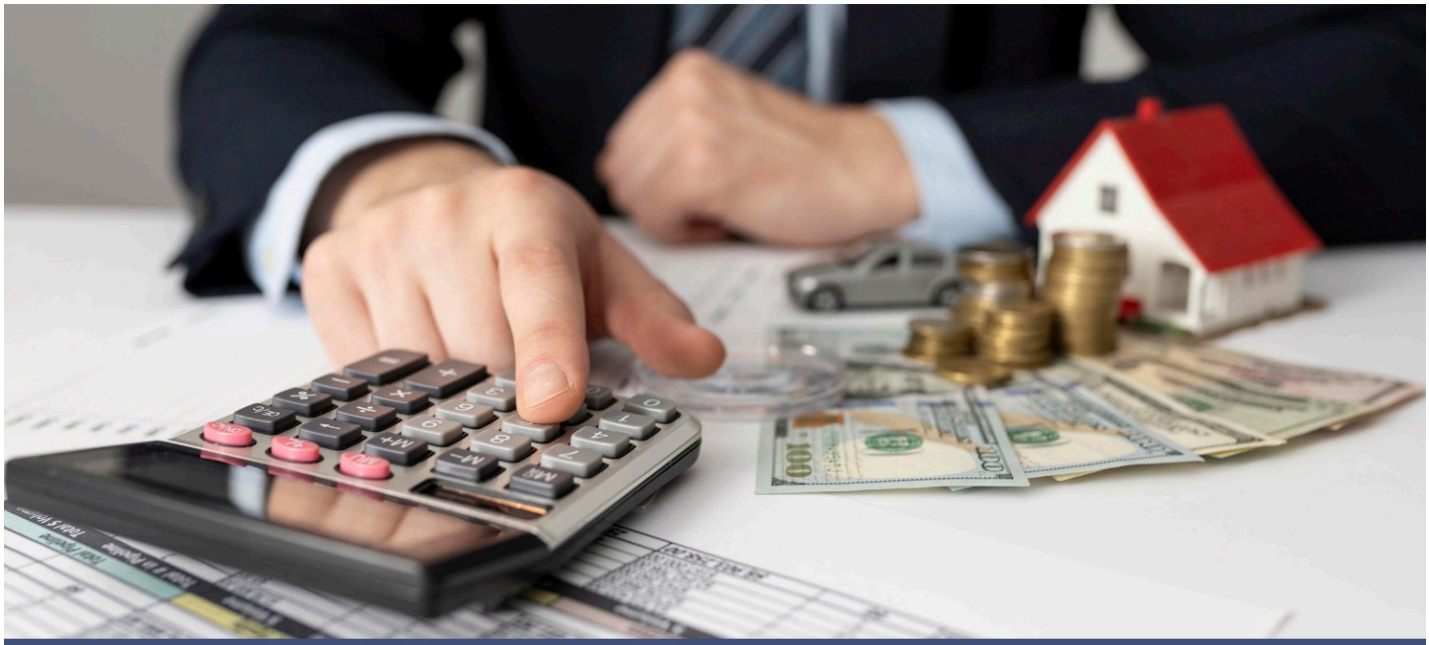
## Four Tier Accounting

All assets in a trust must be allocated to one of four tax characterizations. When money is paid out to a beneficiary, the tax characterization follows with it, meaning that if it went in as long-term capital gain, for instance, it would come out as long-term capital gain and be taxed that way on the beneficiary's personal return.

| TIER 1 | TIER 2 | TIER 3 | TIER 4 |
|---|---|---|---|
| Ordinary Income or Dividends, Short-Term Capital Gains | Long-Term Capital Gains | Tax-Free Income | Return of Principal |

**The CRT rules require that the most highly taxable class of assets be paid out first.**

Think of it as worst out, first out. Only after Tier 1 assets are paid out will the lower-taxed tiers be paid out. This is one reason why the financial team must work so closely with the tax team.



## Prudent Businessperson Rule

You must remember that besides you, the grantor/trustee, there are other parties involved in your trust agreement. There could be other income beneficiaries, but there are also charitable beneficiaries, even though you can change them at will. Intrinsically, however, the IRS is also a party.

You have entered into a written agreement with all of these parties to act as a fiduciary, essentially undertaking a heightened legal duty. There is no higher legal duty than a fiduciary, imposing very serious legal scrutiny, additional requirements, and severe penalties for any lapses, intentional or otherwise. All fiduciaries, therefore, are required to abide by the Prudent Businessperson Rule, which states that a fiduciary must make choices and manage investments that they might make for their own personal accounts.

## Rule Against Self-Dealing

In keeping with the Prudent Businessperson Rule, a fiduciary is strictly not allowed to self-deal, essentially profiting himself at the expense of the trust or beneficiaries. This is an egregious violation of the fiduciary duty, and such violations almost certainly create more trouble than any potential tax savings would be worth, which would be forsaken in any event.

## Unrelated Business Taxable Income

Section 664 (c)(2)(A) imposes a 100% tax on Unrelated Business Income (UBI), which generally occurs when the donor/trustee of a trust wants to “do business” with the trust assets. Clearly a violation of the Section, other taxes, penalties, and interest could be due, as well as a disallowance of the trust’s exempt status.

**There is no need to violate any of the rules or guidelines.**

Charitable Trusts are incredibly beneficial tools just as they are written and utilized.

# Selecting a Trustee

**You have essentially two choices when it comes to selecting a trustee: a professional one or a private one.**

Obviously, the benefit to hiring a professional trustee is that they have experience dealing with all the aforementioned statutes, rules, guidelines, and procedures. The drawback to a professional trustee is that they are not free, as you or your subsequent beneficiaries would be. If your plan is simple and all your beneficiaries are agreeable, then a family member may suffice. If, however, you have a complicated plan with beneficiaries who are distrustful of each other, a professional may be a better choice.

With proper guidance, any responsible adult can act as a private trustee without too much trouble. By bringing all three of the needed disciplines to the same table at the same time, Magellan enables you to confidently act as your own private trustee and choose your own successor trustee. We have been able to reduce the trustee duties to just a couple of signatures a year.

# The Magellan Family of Firms is Perfectly Positioned

**Though the language for the Charitable Remainder Trust mostly comes directly from the Code, the intricacies of designing and maintaining a trust to adhere to all the ancillary rules and regulations is exacting, and requires the close coordination of three disciplines: legal, tax, and financial.**

Magellan Planning Group is a unique tri-disciplinary firm that seamlessly melds these three disciplines for maximum coordination and efficiency.

For a Charitable Remainder Trust, in particular, we are able to engage our sister firm, **Magellan Legal, LLC** to create a proven-successful trust that meets the requirements of the law as well as the desires of the client.

**Magellan Tax, LLC** has many years of experience with the complex tax returns and four tier accounting that accompany the creation and maintenance of a Charitable Remainder Trust. Our multi-disciplinary team approach creates a seamless transfer of information to facilitate this process.

And while the funds are housed in the Charitable Remainder Trust, they need to be actively managed to maximize the income for the beneficiaries as well as the eventual distribution to the chosen charity(ies). The trustee (usually the donor/grantor) has a legal fiduciary duty to the remainder persons—the charitable element—and Magellan can ensure that this legal standard is met.

In addition, there are Prudent Businessperson Rules, Rules against Self-Dealing, and onerous rules regarding Unrelated Business Taxable Income (UBI). Magellan can remove any concerns about staying legally compliant, allowing you to focus on matters that are more important to you.

**Magellan Planning Group manages charitable trusts on a fee-only basis, beginning at 1% per annum and declining based on the size of the trust, thus aligning everyone's financial interests.**

# Fiduciary Team

**In fact, every member of your CRT team is serving in a fiduciary capacity to you, as the grantor/donor and also to the trustee(s) and their successors.**

This imposes the highest legal duty on all of us to do what is in the best interests of our clients, first and foremost.

Needless to say, this type of trust takes professionals who communicate, cooperate, and coordinate. At Magellan, all of our advisors are under one roof—a one-stop-shop, if you will. Clients often tell us this provides them with convenience and confidence, as well as savings.

# FAQs

### What does it cost to set up a charitable trust?

There is the initial legal fee for the trust documents themselves which averages about $3,500. Depending on the type of assets donated to the trust, there could be other associated costs, e.g., appraisals for real estate, collectibles or other hard-to-value items, and auction fees and the like.

### What are the ongoing associated expenses?

If all goes well, the legal team should not be needed again until final distribution. Moving forward, it is in the hands of the tax team and the financial team. Both will charge a flat fee independent of one another, and both fees are paid by the trust. Thus, after the initial legal fees, there are no more out-of-pocket expenses to the donors/grantors.

### Can I do it myself?

It is not impossible if you really know what you are doing, but why take the chance? Just the earnings off a small portion of tax savings will more than cover the expenses. Unfortunately, we do not offer à la carte services for Charitable Trusts since coordination is so important. Due to mistakes by third parties in the past that were outside of our control, our policy is “all or nothing.”

### What if I have an existing charitable trust?

Great! Our legal team will gladly look over your documents to make sure they would qualify for our management. There is no charge for this legal review. If your trust passes muster, we will be happy to integrate you (and your charitable trust) into the family of trusts that we manage. This often reduces the overall trust expense ratio for many reasons. Please contact us to learn why.

### Can I buy real estate from myself with trust funds?

No. This would clearly violate the Rule Against Self-Dealing.

### Can my CPA do the tax return?

We require all CRT returns to be prepared in-house. In the past we have tried to coordinate with outside CPA's, but we have discovered that it is nearly impossible without a great deal of effort. Additionally, most practitioners will charge a significantly higher fee than our normal preparation and accounting fee, since they often have to "get up to speed."

### What states will this work in?

The CRT was created by an Act of Congress and applies to any US citizen in any US state or territory.

### Do I need to travel to Atlanta to execute my documents?

Not necessarily. We have relationships with attorneys in almost every state in the union. For a reasonable additional legal fee (paid to your home state attorney), we can arrange for you to execute the documents through one of our qualified legal colleagues licensed in your state. In some cases, we may recommend an attorney in your home state for other reasons, such as real estate deeds and domestic closely held corporations, partnerships, and the like.

### What if I want to change the charitable beneficiaries of the trust?

Even though the CRT is an irrevocable trust, it is allowable for the grantor/donor to change the ultimate charitable beneficiary(ies).

### What if I want to change the payout rate or the non-charitable beneficiaries?

One of the rules with all CRTs is that they are irrevocable. Generally, that means nothing can be changed, with the exception of the charitable beneficiaries. Therefore, you cannot add or subtract beneficiaries, nor can you change the payout rate or any other particular aspect of the trust. All contingencies are "built in" to the trust at creation. It is usually a comfort to grantors/donors to know that their instructions will be followed absolutely.

### Is the process of setting up a T-CRUT the same as a regular CRT?

For the most part, yes. The only difference is that the Testamentary Charitable Trust is not "funded" until the death of the donor. The donor/grantor would create the trust before death and name the trust as the beneficiary of his or her retirement plan (IRA). Upon death, the proceeds of the retirement plan would pay to the T-CRUT, and systematic payments to the beneficiaries would begin immediately. No maintenance would be needed until this trust "springs" into action upon the grantor's passing.

### How significant is the tax characterization of trust distributions?

This depends greatly on the tax situation of the non-charitable income beneficiaries. If a particular beneficiary is normally in a higher tax bracket, it could be quite important to retain the long-term capital gain tax characterization since it may be taxed at a significantly lower rate. If mismanagement of the trust assets creates ordinary income, the beneficiaries would be taxed on this income at their normal ordinary income tax rate, or perhaps higher.

### How do the Magellan Family's fees compare to others?

Take some time and compare the various trust-associated fees yourself. As stated above, there are at least three entities involved with your charitable trust creation and management, and we have seen situations where sometimes four or five different firms are leaching money from a trust.

The trustee is charged with a fiduciary duty to the current and future beneficiaries of the trust, not to mention the IRS itself. This level of fiduciary duty also imposes a protection against mismanagement, which requires guarding against excessive costs and expenses. Every trustee should know the expenses incurred by a trust, and seek to mitigate them.

Rather than charge a percentage-based fee for accounting, tax-reporting fees, or legal fees, our sister firms charge a flat fee for services, significantly reducing trust expenses—allowing more assets for beneficiaries and charity.

Take time to discover how cost-effective our tri-disciplinary in-house professional cooperation and coordination is—in addition to the simple convenience we provide to grantors, trustees and beneficiaries.

**J. Kevin Meaders, J.D., CFP®, ChFC, CLU**

If you would like a complimentary, personalized illustration, please contact my office at **404-257-8811** or email me directly at **kevin@magellanplanning.com.**

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The views and opinions are those of J. Kevin Meaders, J.D., CFP®, ChFC, CLU and should not be construed as individual investment advice, nor the opinions/views of Cetera Advisor Networks.

All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. Additional risks are associated with international investing, such as currency fluctuation, political and economic stability, and differences in accounting standards. Due to volatility within the markets mentioned, options are subject to change without notice.

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Generally, a donor advised fund is a separately identified fund or account that is maintained and operated by a section 501(c)(3) organization, which is called a sponsoring organization. Each account is comprised of contributions made by individual donors. Once the donor makes the contribution, the organization has legal control over it. However, the donor, or the donor's representative, retains advisory privileges with respect to the distribution of funds and the investment of assets in the account. Donors take a tax deduction for all contributions at the time they are made, even though the money may not be dispersed to a charity until much later.

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